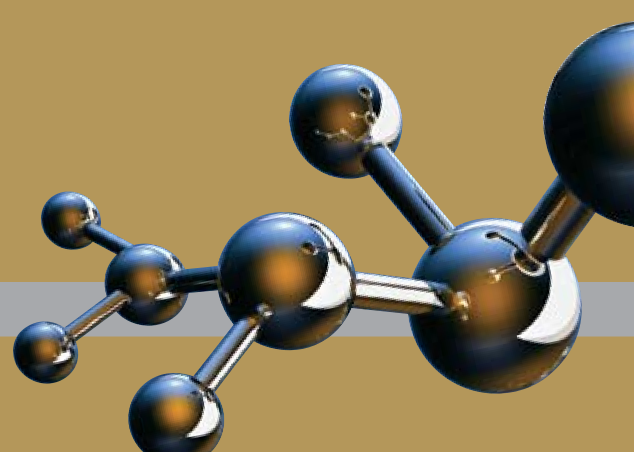
2008

KMG

CEO LETTER TO THE SHAREHOLDERS



Dear Fellow Shareholders:

OVERVIEW

Fiscal 2008 proved to be both a challenging and transformative year for KMG. Challenging in that two of our heritage businesses, Penta and Animal Health chemicals, underperformed our growth and profitability expectations, but nonetheless generated significant profits and operating cash flow. The transformative event took place on December 31, 2007, five months into our fiscal year, when we consummated the acquisition of our Electronic Chemicals business from Air Products and Chemicals, Inc., which contributed $2.1 million to operating income and was modestly accretive to 2008 earnings despite significant non-recurring integration costs throughout the year. This transaction doubled the size of KMG, added another platform on which we may build, and balanced our portfolio with further market diversification.

In fiscal 2008 our financial results were mixed. Net sales were up nearly 80% to $154.4 million from the prior year's $86.2 million, due in great part to the inclusion of the Electronic Chemicals business, but income from continuing operations declined year-over-year, to $5.7 million or $.50 per diluted share, from fiscal 2007's $9.2 million or $.83 per diluted share. Despite the one-year hiatus in profit growth, our four-year compound annual growth rate in net income from continuing operations is nearly 27%. We borrowed $64 million under a new credit facility on December 31 when we closed the Electronic Chemicals acquisition and reduced debt by $9 million over the next seven months using the cash flow from operations KMG generates.

Financial Highlights

(thousands, except per share amounts)	2008	2007	2006	2005	2004
Net Sales	$154,394	$86,171	$67,200	$55,064	$39,931
Gross Profit	46,831	30,436	23,625	17,396	12,291
Operating Income	11,493	15,118	9,923	5,770	3,821
Income from Continuing Operations	5,656	9,163	5,935	3,285	2,200
Earnings per Diluted Share	0.50	0.83	0.63	0.40	0.29
Weighted Average Diluted Shares Outstanding	11,232	11,034	9,447	8,256	7,631
Total Assets	155,798	81,233	72,702	61,103	43,240
Total Shareholders' Equity	63,687	56,410	46,918	32,888	24,590
Long-term Debt, Net of Current Portion	53,516	10,468	13,981	17,644	11,235
Depreciation and Amortization	5,665	3,832	3,889	2,204	1,643

* The results for 2004 through 2008 have been adjusted to reflect the discontinuation of the MSMA product line which had comprised the Company's agricultural chemical segment.

Milan, Italy, Peroxide Unit

Neither I nor anyone within the KMG organization is satisfied with our fiscal 2008 earnings. We were disappointed in the performance of Animal Health and Penta, both of which unfortunately suffered from lower demand driven by negative economic dynamics in the markets served. Penta profits also suffered during the year from a 35% price spike for one of our key petroleum-based raw materials. We are looking for a much better bottom line performance in fiscal 2009. The inclusion of the Electronic Chemicals business for an entire year should bring total net sales to $200 million. At the same time, there will be a significant reduction in certain operating expenses including those integration costs incurred in fiscal 2008 and the first quarter of fiscal 2009. The benefit of those savings will be fully apparent beginning with our second fiscal quarter of 2009 since the business was fully integrated into our systems and operations beginning October 1, 2008.

The full balance sheet published in the Annual Report on Form 10-K that follows this letter illustrates KMG's financial strength. At year end, our current ratio was 1.8 to 1. Also, our debt to equity was less than 1 to 1, just seven months after closing the Electronic Chemicals acquisition. At year end, we had $29.8 million of availability under our $35 million revolving line of credit, and a comfortable margin on the three financial ratios required by the credit agreement with our bank group. Similarly, our statement of cash flows highlights the amount of cash KMG generates, which we will continue to use to pay down debt, and to a lesser extent, pay a quarterly cash dividend to you, KMG's owners.

Thanks to repeated success in executing our business strategy, which entails identifying, acquiring, integrating and optimizing stable chemical businesses, KMG is positioned to provide needed products to vital infrastructure markets, including utilities, railroads, agriculture, and now, the computer chip market. While each segment we serve has its drivers and detractors, each of those markets is here to stay.

KMG's infrastructure was enhanced significantly during fiscal year 2008. The enhancements implemented to facilitate the integration of the Electronic Chemicals business not only support the far larger organization we have become, but more importantly, we will be able to leverage the upgrades and expansions in IT, human resource management, process controls, and bench strength across our management spectrum, which should translate into integration efficiencies for future acquisitions.

Our Business Segments:

WOOD TREATMENT

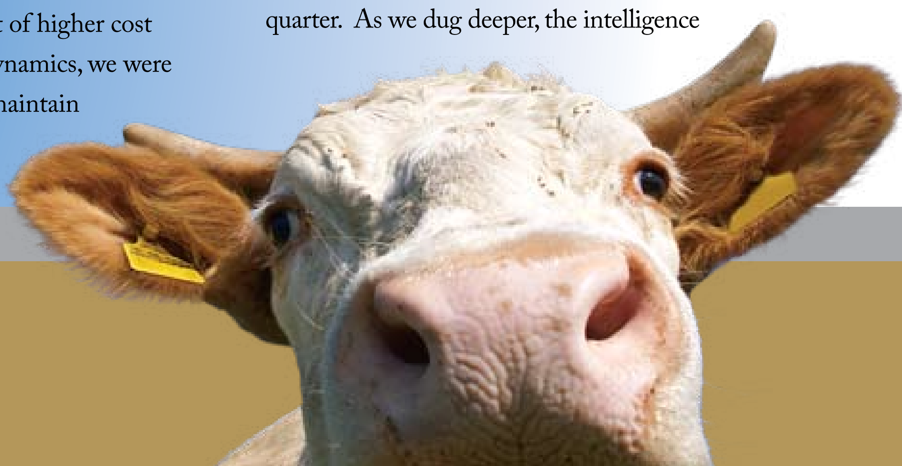
I want to address the issues confronting our Wood Treatment chemical businesses, their performance in fiscal 2008, and the actions we have taken to optimize their operations in fiscal 2009 and beyond. Through the first half of the fiscal year, sales of Wood Treatment chemicals were well ahead of the prior year. But in the winter and spring of 2008, sales of high-margin Penta - the industrial wood preservative used to treat utility poles - declined, and for fiscal 2008, were $26.4 million compared to $28.4 million in fiscal 2007. In the third quarter, a confluence of factors, mostly driven by notable inflation in commodity pricing, depressed the sales and profitability of Penta, starting with a significant increase in the price of the distillate oil that our customers blend with Penta to treat utility poles which caused a dramatic, although temporary, decline in pole purchases by utilities. Additionally we experienced a 35% cost increase in a key petroleum-based raw material resulting in a lower gross margin. Sales of Penta resumed at a more normalized rate in our fourth quarter and were on par with the prior year's fourth quarter. We also implemented a price increase in June to offset some of the cost increase we have experienced.

Sales of Creosote, the industrial preservative used by wood treaters primarily to produce railroad crossties, increased more than 26% to a record $55.2 million from $43.6 million in fiscal 2007, and its contribution to profit was also a record. During the year, we implemented price increases to mitigate the impact of higher cost of goods. However, due to market dynamics, we were unable to raise prices sufficiently to maintain gross profit margins. We are doing everything we can, in partnership with both customers and suppliers, to minimize the impact of operating and raw material costs. At the same time, we continue to maintain a very efficient and cost-effective supply chain to ensure that material is available for customers on demand. On the subject of demand, the Creosote market remains fundamentally sound. With the United States' increasing reliance on the railroad system to transport freight, railroad maintenance is a high priority which will require an estimated 20 million ties per year.

One very important note with respect to our Wood Treatment chemical business, we have received the final notification from the EPA that Penta and Creosote have been re-registered. These registrations are basically our license to do business in the United States, and the long term health of both registrations appears to be very solid.

ANIMAL HEALTH

Moving on to Animal Health, following an exceptionally but atypically strong first half due in part to some early stocking of our Avenger® ear tags, business fell off sharply in the spring of 2008. From initial discussions with distributors, who are closer to the end customer than we are, we learned that cool weather in the key cattle markets delayed the onslaught of the fly season until the fourth quarter. As we dug deeper, the intelligence



Avondale Facility

pointed to more profound micro-economic factors, namely higher prices for necessities of livestock farming such as feed, fuel and fertilizer that were root causes for the decline in discretionary purchases by cattle growers, including ear tags. As the cattle business has become less profitable, cattle farmers have been culling their herds, to the tune of over one million head in the last two years, according to the U.S. Department of Agriculture. Thus while it appears that our Animal Health unit did not lose market share, and Avenger remains the #1 selling insecticidal ear tag for cattle in the U.S., the domestic market contracted and our high-margin Animal Health sales declined to $11.7 million from $14.1 million last year. Even though this business was dramatically down, it still contributed over $1 million of operating income.

We still believe Animal Health is a sound market, and we view this downturn as a temporary setback, but have taken decisive action to enlarge this business unit by entering new geographic markets in the short term and through acquisitions further out. To both grow and minimize the seasonality of our Animal Health business, Latin America has been targeted because these countries have either year-round warm weather or are situated below the equator and their seasons are the reverse of those in the northern hemisphere.

We are naturally focused on opening markets in countries with very large livestock industries. Good progress has been made thus far, with registrations granted in Puerto Rico, Mexico, and Argentina and shipments have been made to all three countries. Registrations are pending in Colombia, Venezuela and Brazil, with further applications to be submitted in the near future. We have forged relationships with key distributors, and are providing the necessary training, translations, and all other requirements to ready the product for local sale. To drive organic growth, we have introduced three new product line extensions, plus we have in trials a new ear tag which we hope to commercialize in 2010.

Aerial View of Elwood Plant

Entrance to Pueblo, Colorado, Facility

ELECTRONIC CHEMICALS

Our latest and by far the largest acquisition, is the Electronic Chemicals business we purchased from Air Products. This represents our seventh successful transaction in six years and with this acquisition, we have added an important new business platform with attractive growth opportunities. Our Electronic Chemicals enterprise produces high purity wet process chemicals used to clean, etch, and otherwise prepare the surface of semiconductor products. This acquisition is the largest U.S. supplier of high purity process chemicals to the semiconductor market, with an estimated 40% market share and Europe's third largest with an estimated 15% market share. We paid $72.5 million for the business, which consisted of $48.5 million for property, plant and equipment, as well as $1.1 million for intangible assets, $22.9 million for accounts receivable and inventory net of assumed liabilities, plus $2.5 million of transaction costs paid to other parties. The acquired business and assets were appraised at significantly greater than the purchase price resulting in no goodwill. The acquisition was financed with cash on hand and our new credit facility.

We now own and operate state-of-the art production facilities and warehouses in Pueblo, Colorado, and Milan, Italy. This Electronic Chemicals business has grown under our ownership, from approximately $91 million for 12 months ended September 30, 2007, to its current annualized run rate of $105 million.

As noted earlier, the acquisition was accretive to earnings in FY'08, but only modestly due to transition and integration costs. Thanks to the extraordinary efforts of many, the integration and associated costs are now behind us. The combination of internal growth stemming from new and profitable business from several major global customers, our lower overhead structure, and the elimination of transition and integration costs, points to a vastly improved profit picture for KMG's Electronic Chemicals business in the new fiscal year. This acquisition forms a firm foundation on which to build with other quality transactions.

Through this acquisition, KMG's business interests are far more diversified. This diversification, both in terms of customers served and geographic markets, helps mitigate business risk, be it from commodity prices to weather. In fiscal 2007, Wood Treatment represented 80% of KMG's sales and 16% were from Animal Health sales. In fiscal 2009, approximately 52% of net sales will be generated by the Electronic Chemicals segment with 40% coming from wood treating products and 8% from Animal Health.

CORPORATE STRATEGY

Meeting our objective of continued growth in earnings and shareholders' equity hinges upon our focus on three core competencies: maximizing free cash flow from current operations, identifying and acquiring businesses that are immediately accretive to cash flow and earnings, and rapidly and cost effectively integrating acquisitions, thereby harvesting synergies and again maximizing earnings and cash flow to further strengthen our balance sheet to facilitate future acquisitions. This has proven to be a successful format for KMG and continues as the driver for meeting our growth objectives.

MAKING THE GRADE

Once again, KMG's growth and success has been recognized by *FORTUNE Small Business* and was named to the "FSB 100" list of America's fastest-growing small public companies, ranking #72. More recently, we made the Forbes list of "America's 200 Best


Pueblo Electronics Lab


Pueblo Electronics Chemical Truck Bay


Electronic Chemicals Warehouse in Pueblo

Exterior Shot of Milan Plant

Small Companies" as #167. We were also awarded the #45 spot on The Houston Chronicle's "Chronicle 100," which ranks the top 100 leading companies in Houston.

LOOKING FORWARD

We view the current depressed economy as a potential business opportunity in that it may "free-up" acquisition targets at more attractive multiples. Our priority is an enterprise engaged in Wood Treatment, Animal Health or Electronic Chemicals. KMG has a solid foothold in these sectors, and we are actively assessing opportunities in all three.

For 2009, we have forecasted $200 million in net sales, and a substantially improved profit picture. With a current annualized run rate of $105 million, our Electronic Chemicals business will be consolidated for the entire fiscal year. We anticipate that in fiscal 2009, demand for both of our wood treating chemicals will approximate fiscal 2008 levels. The average cost for Creosote is expected to remain at or above fiscal 2008 levels, while certain Penta raw material costs, which increased significantly over 2007 levels, should remain flat in fiscal 2009. We have and will continue to do our best to pass through higher costs to the market as they are incurred. While we are hopeful that U.S. Animal Health product sales will resume normalized levels, Latin American sales should enable us to grow that product line in this fiscal year. With the additional revenues from Electronic Chemicals comes growth in net income and diversification in

Tote Exiting Fill Room, Milan

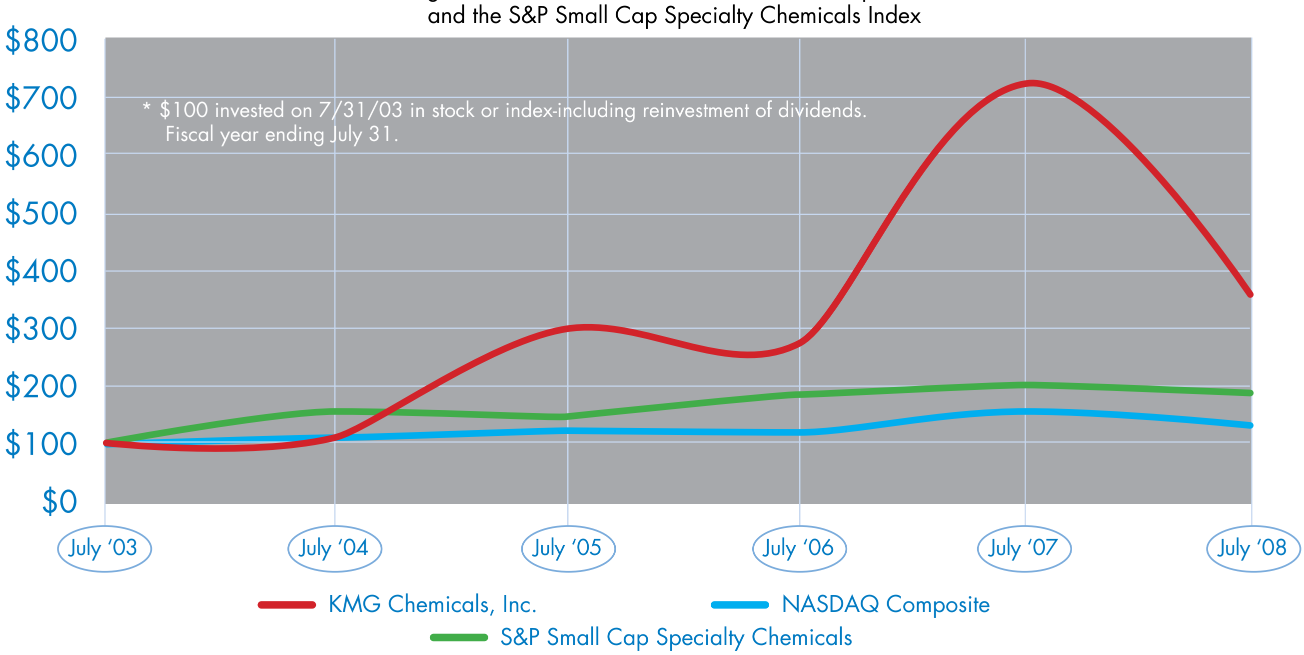
Milan Lab

markets, products and geography. Also, certain operating expenses incurred in fiscal 2008 and the first quarter of fiscal 2009 in connection with the integration of the Electronic Chemicals business are eliminated in the last three quarters of fiscal 2009, plus another $1.2 million of amortization of certain intangible assets beginning in December 2008, effectively reducing fiscal 2009 depreciation and amortization by $800,000.

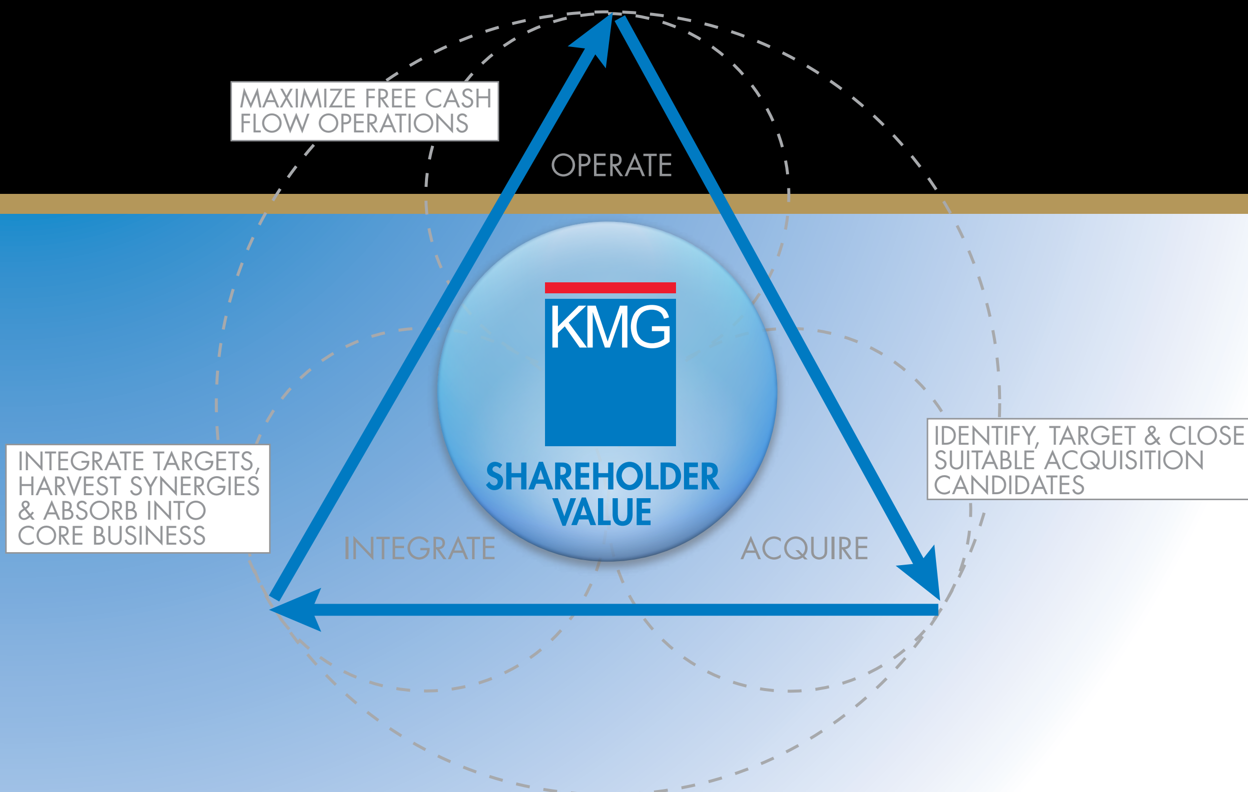
Today's global economic situation is uncertain, and we share the same concerns with forecasting results as those of you reading this letter. However, we do believe our business attachment to key infrastructure industries provides a measure of stability and continuity. We will continue to take a disciplined approach to identifying and acquiring new businesses using fiscal 2009 to prepare for our next acquisition which we look to complete in fiscal 2010.

Comparison of Five Year Cumulative Total Return*

Among KMG Chemicals, Inc., The NASDAQ Composite Index
and the S&P Small Cap Specialty Chemicals Index



The graph above compares our cumulative total stockholder return since July 31, 2003, with the NASDAQ Composite Index, and the S&P Small Cap Specialty Chemicals Index. The graph assumes that the value of the investment in our common stock and each index (including reinvestment of dividends) was $100.00 on July 31, 2003.



The execution of KMG's strategy is built on the pillars of three core competencies: operational excellence, target identification and acquisition, and acquisition integration

Over the course of this fiscal year, we will utilize cash flow from operations to pay down debt, improve efficiencies particularly in the newly integrated Electronic Chemicals business, and reload our balance sheet. I am optimistic about our growth opportunities in fiscal 2009 and believe we have the management strength, talent pool and market position to achieve our growth objectives.

Sincerely,

J. Neal Butler

President and CEO

J. Neal Butler
President,
Chief Executive Officer

SHAREHOLDER INFORMATION

Transfer Agent and Registrar

Communications concerning the transfer of shares, lost certificates, or changes of address for registered shares should be directed to the transfer agent:

Securities Transfer Corporation,
2591 Dallas Parkway, Suite 102, Frisco, Texas 75034
Voice: 469.633.0101 Fax: 469.633.0088
Email: info@stctransfer.com
Website: www.stctransfer.com

Direct Stock Purchase Plan

The Company has a Direct Stock Purchase Plan (DSPP) for registered shareholders. Participants may invest in KMG common stock at current market prices without service fees or brokerage commissions, and automatically reinvest KMG dividends into additional common shares. Participants may also use the plan to make gifts of KMG common stock, deposit existing stock certificates for safekeeping and sell KMG shares.

Securities Transfer Corporation (STC) is the plan administrator. The DSPP prospectus can be obtained from KMG's website, www.kmgchemicals.com, at STC's website, www.stctransfer.com, or by calling 713.600.3814. This is not an offer to sell or a solicitation to buy securities, which are only offered by prospectus.

Shareholder Services

KMG maintains an internal financial mailing list and can email you when news releases are distributed. To sign up, visit the website at www.kmgchemicals.com and click on Investor Relations. You can also request that certain financial information be mailed to you on a one-time basis, by contacting the corporate office.

Code of Business Conduct

KMG's Code of Business Conduct can be viewed and downloaded from the home page of the Company's website at www.kmgchemicals.com. Copies are also available at no charge by contacting John V. Sobchak, Chief Financial Officer, at the address on the back cover.

Form 10-K

Additional copies of the KMG Chemicals, Inc. Form 10-K, as filed with the Securities and Exchange Commission, can be downloaded from the Company website and are also available upon written request to the corporate offices.

NASDAQ Prices for KMG Common Stock ($ per share)

	High	Low
Q1 ending October 31, 2007	26.75	13.65
Q2 ending January 31, 2008	17.27	12.69
Q3 ending April 30, 2008	17.70	13.03
Q4 ending July 31, 2008	14.50	9.71

As of October 10, 2008, there were 11,059,795 shares of common stock outstanding, held by approximately 500 shareholders of record.

Independent Accountants

UHY LLP - Houston, Texas

Investor Inquiries on Company Activities

Inquiries about KMG are welcome by email, phone, fax or letter. Please direct them to:

Investor Relations

Melissa Dixon, Sr. Account Executive
The Equity Group Inc.
800 3rd Avenue, 36th Floor
New York, NY 10022
Voice: 212-836-9613
Email: mdixon@equityny.com
Website: www.theequitygroup.com

KMG

KMG Chemicals, Inc., 9555 W. Sam Houston Parkway S., Suite 600, Houston, Texas 77099
Phone: 713.600.3800 Fax: 713.600.3850 Nasdaq: KMGB www.kmgchemicals.com